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No. 566

IN THE

Supreme Court of the United States

October Term 1947

EDWARD P. FLETCHER,

Petitioner,

—*vs.*—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

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Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Laurence Sovik, Esq., on behalf of Edward P. Fletcher, petitioner, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Second Circuit entered in the above entitled action on November 5, 1947, affirming the decision of the Tax Court of the United States entered November 29, 1946.

Opinions Below.

The opinion of the Tax Court of the United States is reported in 7 T. C. 1186. The decision of the Circuit Court

of Appeals for the Second Circuit was reported in 164 Fed. (2d) 182.

Jurisdiction.

Jurisdiction is invoked under Sec. 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, 28 U. S. C. A., Sec. 347, 43 Stat. 938.

The decision which petitioner seeks to have reviewed was handed down by the Circuit Court of Appeals for the Second Circuit on November 5, 1947.

Statement.

The Commissioner of Internal Revenue assessed a deficiency in the amount of $8,091.09 in petitioner's income tax for the calendar year of 1941. The assessment of this deficiency was affirmed by the Tax Court of the United States by an order entered on November 29, 1946.

In 1925 petitioner organized the Fletcher Oil Company (R. 5). Petitioner was the sole owner (R. 5). The company was engaged in the wholesale distribution of gasoline, motor oils, tires, batteries and kindred supplies in the city of Utica, New York. It included originally one service station expanding between 1925 and 1941 to six stations and from ten to fifteen dealers (R. 5). The company also acquired real estate upon which its stations were erected (R. 6). As of January 1, 1941, the company had fixed assets—land and buildings, with a book value of $137,308.48; and machinery and equipment with a value of $72,018.46 (R. 5-8, Ex. 1).

In 1941 petitioner was married, living with his wife and infant daughter. Petitioner had two adult sisters and two adult brothers (R. 8-9), none of whom lived with petitioner or constituted a part of his household (R. 12). Petitioner's brother, Vincent Fletcher, became identified with the business of the Fletcher Oil Company as an employee while he was still attending school (R. 9). After completing his college education in 1932 Vincent Fletcher devoted his full time to the business and has continued to do so since that time (R. 9). For many years Vincent Fletcher has had complete charge and management of all phases and departments of the business (R. 15, 16, 21).

In 1940 petitioner assigned to his sister, Helen Fletcher, as a gift an interest in the equity in said business equivalent to $50,000.00 (R. 11). Petitioner filed a gift tax return and paid the gift tax thereon (Ex. 3, R. 11). At or about same time petitioner entered into a partnership agreement with his sister, Helen Fletcher, which in substance confirmed said gift and allocated to her on the books of the Fletcher Oil Company an interest in the capital equivalent to $50,000.00 (R. 11, 14, 15); this representing something less than one-third of petitioner's equity in the business.

The Commissioner taxed all the profits of the Fletcher Oil Company as income to the petitioner. Petitioner claims that his sister, as the result of the gift by him and the creation of the partnership, became a bona fide partner and that petitioner is liable only for the tax on his distributive share of the partnership earnings.

The Question Presented.

Whether all of the income of a partnership is taxable to one partner where that partner has made a gift to his sister of a $50,000 interest in a business whose earnings are attributable to the physical assets of the business and not to any services rendered to the business by the partner making the gift and where the partner making the gift had no right to exercise any control over the earnings of the other partner.

Statutes and Regulations Involved.

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U. S. C. 1940 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

(a) As a part of his short-term capital gains or losses, his distributive share of the net short-term capital gain or loss of the partnership.

(b) As a part of his long-term capital gains or losses, his distributive share of the net long-term capital gain or loss of the partnership.

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

(26 U. S. C. 1940 ed., Sec. 182.)

SEC. 3797. DEFINITION.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * *

(2) *Partnership and Partner.* The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organiaztion, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * *

(26 U. S. C. 1940 ed., Sec. 3797.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * * In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. * * *

SEC. 19.181–1. *Partnerships.*—Partnerships as such are not subject to taxation under the Internal Revenue Code, but are required to make returns of income. * * *

SEC. 19.182–1 [as amended by T. D. 5217, 1943 Cum. Bull, 314, 336]. *Distributive share of partners.*—(a) Each partner is required to include in his return for his taxable year within which or with which the taxable year of the partnership ends, whether or not distributed:

(1) For any taxable year beginning after December 31, 1938, and before January 1, 1942, as part of his short-term capital gains or losses, his distributive share of the net short-term capital gain or loss of the partnership; and for any taxable year beginning after December 31, 1941, as part of his gains and losses from sales or exchanges of capital assets held for not more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than six months.

(2) For any taxable year beginning after December 31, 1938, and before January 1, 1942, as part of his long-term capital gains or losses, his distributive share of the net long-term capital gain or loss of the partnership; and for any taxable year beginning after December 31, 1941, as part of his gains and losses from sales or exchanges of capital assets held for more than six months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than six months.

(3) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

Specification of Errors to be Urged.

1. Taxpayer did not reserve complete management of the business in himself.

2. The Circuit Court of Appeals erred in holding that taxpayer's sister as a partner could not make withdrawals without the consent of the taxpayer.

3. The Circuit Court of Appeals erred in holding that taxpayer had a pre-emptive right to purchase his sister's interest at the amount of his original gift no matter what the value of the sister's interest might be.

4. The decision of the Circuit Court of Appeals is erroneous and should be reversed.

REASON RELIED UPON FOR WRIT.

The Circuit Court of Appeals for the Second Circuit has decided a federal question in a manner in conflict with applicable decisions of this Court.

In *Commissioner v. Tower*, 327 U. S. 280, and *Lusthaus v. Commissioner*, 327 U. S. 293, this Court refused to recognize as valid for income tax purposes partnerships existing between husband and wife where the wife's interest in the partnership came initially by way of a gift from the husband and the wife did not contribute services to the partnership.

The *Tower* case did not invalidate all family partnerships. It conceded that under certain circumstances even a husband and wife could be partners for tax purposes. Decisions in other circuits have recognized this fact. Lawton v. Commissioner, 164 Fed. (2d) 380; Durwood v. Commissioner, 159 Fed. (2d) 400.

In applying the *Tower* rule to the facts of this case where the earnings of the partnership stem from partnership assets rather than from any services of the former sole proprietor, who was gradually relinquishing supervision and management of the business to another brother, is to misapply the *Tower* rule.

Income earned from capital acquired by Helen Fletcher by gift from petitioner was income to her and not income earned by petitioner and taxable to him.

The Fletcher Oil Company is a business earning its income from tangible assets—gas stations, real estate, equip-

ment and inventories. The business during the period in question and for a considerable time prior thereto was actively managed and in complete charge of petitioner's brother, Vincent Fletcher (R. 16, 21). Admittedly it is not a business whose income is earned by the personal service of petitioner. The only question seems to be whether petitioner had a right to give away a portion of his equity in that business and as a result thereof whether the income earned from that equity is taxable to the recipient of the gift. Had the business been incorporated and had the petitioner given to his sister the equivalent amount in corporate stock, the dividends thereon would not have been taxable to the petitioner but to the owner of the stock. This would be true regardless of the fact that the donor also owned stock in the corporation and continued to have some control over the management of the corporation.

The many cases on family partnerships revolve around the basic principles as to whether there is the intent to divide earnings resulting from personal service and also whether there has been an arrangement consisting of an attempt to shift income from the taxpayer to his near relatives without any significant economic change.

Commissioner vs. Tower, 327 U. S. 280.

Lusthaus vs. Commissioner, 327 U. S. 293.

Durwood vs. Commissioner, 159 Fed. (2d) 400.

There is nothing in the Internal Revenue Code that distinguishes one kind of property from another with respect to gifts and gift taxes with the possible exception of life insurance. Had the petitioner given his sister a share of his holdings in income producing bonds, stocks, real estate or any other kind of income producing property other

than that resulting from his personal service there would have been no question raised that the income from the portion given away would have been taxable to the donee and not the donor. That being so, why should the Commissioner claim that the earnings from that portion of the equity given by petitioner to his sister should continue to be taxable against petitioner after the gift?

The Tax Court has found as a matter of fact that the earnings of the company did not result from petitioner's personal service.

The undisputed evidence is to the effect that the active and complete management of the business during the period in question had devolved upon Vincent Fletcher, petitioner's brother. The Tax Court said in its findings of fact that—

> "The petitioner's brother, Vincent, was given increased responsibility by the petitioner and had practically full charge of the retail branch of the business either shortly before or shortly after the agreement of July, 1941."

Hence the usual type of family partnership arrangement which is prohibited does not exist here.

The very least that can be said is that petitioner is entitled to a determination, measuring the amount of income attributable to the capital owned by Helen Fletcher and the amount of income attributable to the capital owned by the petitioner and the services, if any, rendered by the petitioner to the partnership.

Canfield v. Commissioner, 7 T. C. 944.

In *Commissioner v. Tower,* 327 U. S. 280, the Supreme Court said:

> "The issue is who earned the income * * *. To decide who worked for who, otherwise created or controlled the income, all steps in the process of earning the profits must be taken into consideration."

With the active management of the Fletcher Oil Company under the direction of Vincent Fletcher, it cannot be said that petitioner alone created the right to receive and enjoy the benefit of the income earned by the partnership. The Fletcher Oil Company was a going concern with a good reputation for fifteen years and well over a quarter of a million dollars in assets. Its profits resulted from those factors and not from personal services rendered by petitioner. That being so, it cannot be said that petitioner created the right to receive and enjoy the benefit of the income of the partnership so as to make it taxable to him.

To sustain its decision, the Circuit Court of Appeals has stated that "the taxpayer at bar reserved complete management of the business * * *." It is submitted that the provision in the partnership agreement providing that—"Edward P. Fletcher shall continue as the General Manager of the partnership"—falls far short of a reservation of the powers of complete management in the taxpayer. A partnership must have a general manager. It does not follow that complete management resides in the general manager when there is more than a sole proprietor. Clearly the actions of a general manager are subject to the control of all of the partners even though the general manager himself be a partner.

The Circuit Court of Appeals stated and attached great significance to the fact that the taxpayer had a pre-emptive right to buy the sister's interest at the amount of the original gift regardless of what the value her interest might be at the time of the purchase. A reading of the partnership agreement as a whole makes it abundantly clear that if the sister's interest was to be purchased, it was to be purchased at its book value which would take into account any increase in its value. Moreover, while the words "pre-emptive right to buy" are used in the opinion, it will be noted that if the sister did not wish to sell her interest, the taxpayer could not acquire it at any price. Such provisions are very common in partnership agreements.

The making of the gift and the partnership agreement resulted in a bona fide and substantial change in petitioner's economic status.

Other than this partnership agreement, there were no other agreements of any kind pertaining to the business between petitioner and Helen Fletcher, nor has any change been made to the agreement since 1941. Helen Fletcher has received her distributive share from the partnership during every year since 1941. Neither did any of the income received by her find its way back to petitioner. The income paid to her was and remained her sole and exclusive property, free from any "strings" (R. 25). With a substantial portion of these profits Helen Fletcher purchased United States Savings Bonds which were registered in her own name and constitute her sole and exclusive property (R. 26-27).

Petitioner's design in creating this partnership was to build up his sister's estate and assure her financial support

and independence, and because of petitioner's peculiar financial condition this was the only practical means available to him of carrying out this intent without disposing of the business or some portion of its assets (R. 10).

Petitioner's economic interest in the Fletcher Oil Company changed, both by virtue of the gift, the creation of the partnership and the distribution of profits to Helen Fletcher, pursuant to the terms of the partnership agreement.

The courts have always subjected to special scrutiny transactions between husband and wife which are calculated to reduce family taxes. (*Helvering v. Clifford*, 309 U. S. 335.) Such scrutiny is understandable and commendable. When it comes to a question of a husband and wife partnership, it is difficult to disregard the unit of the family and to permit the division of income into two parts for tax purposes, when the husband and wife pool the income for all other practical purposes. The courts have sided with the tax authorities and have taken the realistic point of view. They have realized that the husband, as head of the family, still controlled the income derived by both him and his wife and that the income channeled to the wife by means of a partnership device was still used for the same family purposes for which it was used prior to the creation of the partnership.

In the instant case, the family partnership rule is inapplicable for, as indicated above, we are not concerned with one family, but two separate and distinct families, living separate and apart. When a married man lives with his wife, his family consists of himself, his wife, and his

children. An adult sister living in a separate home is not a part of a married man's family.

There is a good reason for not applying the *Tower* rule to cases involving persons who are not husband and wife. The husband is under a duty to support his wife, and where partnership earnings are divided with the wife as a partner, the earnings are paid to a person whom the taxpayer is under a duty to support. The rule taxing the income of the wife-partner to the husband is understandable when considered in that light. Where, however, as here, the taxpayer, a brother, is under no duty to support his partner, a sister, and the partnership earnings are not used to discharge a duty to support, there is no reasonable basis for taxing the entire earnings of the partnership to the brother.

When one-third of the net earnings of the Fletcher Oil Company was paid to Helen Fletcher she was free to do with it as she wished. Prior to the execution of the partnership agreement, 100% of the earnings of the company were available to petitioner for his own and his family purposes. Petitioner testified that one of the reasons for the gift of the $50,000 interest in the business was "to help along so that she might build up some sort of an estate for herself" (R. 10). Such a motive is inconsistent with the Commissioner's contention that the entire income of the business was subject to the control and domination of petitioner.

From withdrawals of her share of the partnership profits in 1941, Helen Fletcher purchased Savings Bonds of an aggregate value of $7,500. They were registered in her own name as sole owner and represented part of her per-

sonal estate (R. 27, Ex. 6). Petitioner had no control over or any right to control those bonds.

In the case at bar, the Court cannot say with propriety that the mere fact that this partnership agreement existed between brother and sister it is for that reason not bona fide and falls within the partnerships condemned in the *Tower* case. By the same token, it might be argued that a partnership between first cousins and, reducing it to an absurdity—forty-second cousins—should be condemned. The test is not whether the partners are, in fact, related, but whether the partnership is "bona fide" and, if so, then the Tax Court must recognize it for tax purposes, just as any other court must recognize it for any other purpose. There is no claim of lack of good faith.

In the *Tower* case, supra, the Supreme Court said:

> "It is the command of the taxpayer over the income which is the concern of the tax laws. Harrison v. Schaffner, 312 U. S. 579, 61 S. Ct. 759, 85 L. Ed. 1055."

Did the petitioner here have any command over the interest in the partnership given to his sister or the income traceable thereto? Obviously not, and in this connection it is to be noted that the contention that a taxpayer exercises command over the income of his partner must be based on fact and not upon mere speculation. *Durwood v. Commissioner,* 159 Fed. (2d) 400.

Absent any showing that the donor could exercise any control over his partner's income, it was error to ignore the partnership agreement and tax all of the earnings of the partnership to the petitioner.

By misinterpreting the partnership agreement and by relying on its misinterpretation of the agreement as a basis for its decision the Circuit Court has decided the case at bar in conflict with applicable decisions of this Court.

CONCLUSION.

It is therefore respectfully submitted that for the reasons above stated this petition for a writ of certiorari should be granted.

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January 28, 1948.